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DIRECTORATE OF INTELLIGENCE

# Intelligence Memorandum

## *Panama's Budget Crunch*

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
May 1971

INTELLIGENCE MEMORANDUM

# Panama's Budget Crunch

## Introduction

1. The military regime of National Guard Commander Omar Torrijos, who seized power in October 1968, has greatly increased government spending during the past two years to offset lagging private investments and build political support. Reflecting the monetary constraints imposed by Panama's use of the Yankee dollar as its currency, a significant part of the expanded outlays was financed with foreign short-term borrowing. This year, budget strains induced partly by the large rise in debt service requirements are forcing a contraction of public investment outlays. This memorandum reviews Panama's budget difficulties and assesses the prospects for easing them over the next three years.

## Discussion

### Background

2. Panama's current financial problems follow a long period of rapid, relatively orderly economic progress. The growth of gross domestic product (GDP) in 1961-67 -- the most rapid in Latin America -- was sparked by expansion in manufacturing and construction, by strong export performance (particularly in sale of goods to the Canal Zone), and by rising wages for that 10% of the country's urban labor force employed in the Zone. Growth

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*Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.*



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was also aided by sizable direct US investment mainly in manufacturing, commerce, and banking -- which totaled about $1 billion at the end of 1969. US investment was encouraged by Panama's use of the US dollar and the narrow limits thus placed on financial and foreign exchange regulation. Although Panamanian governments incurred budget deficits in the mid-1960s, rising revenues (aided by economic growth and fiscal reforms) helped keep them small. These deficits were financed without great difficulty through domestic bond sales and foreign aid receipts.

## Origin of Panama's Financial Problems

3. In 1968, Panama's enviable record was disrupted. Business confidence was shaken by a turbulent election campaign and by Torrijos' subsequent takeover from newly-elected President Arnulfo Arias. The growth of private investment and GDP both slowed significantly. Urban unemployment rose a little as increasing numbers of the substantial annual flow of migrants from the countryside failed to find jobs (see Figure 1).

4. The investment climate was further disturbed in 1969 by Torrijos' strongly reformist posture. Early in the year the new regime announced plans for a sweeping agrarian reform program and nationalized the workers' compensation insurance system -- heretofore in private hands. It also talked of nationalizing a number of cement, dairy, and sugar firms and establishing several plants to compete with private companies. Even more upsetting to business interests was the regime's plan to organize a national labor union, to be nurtured as its political base. As a consequence, the private sector cut its investment 10% compared with 1968.

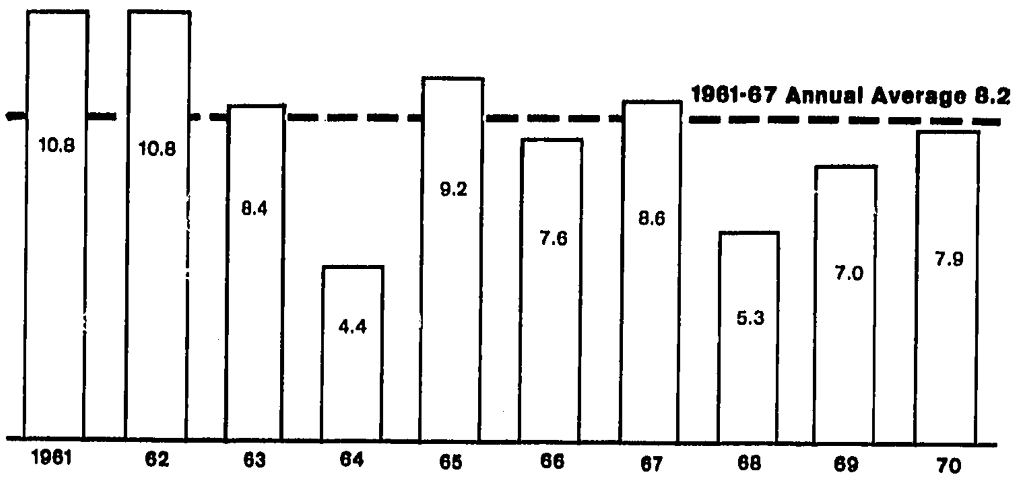
## Torrijos' Expansionary Spending Programs

5. To offset falling private investment and develop his image as a public benefactor, Torrijos more than doubled central government investment in 1969 compared with a year earlier. Government spending rose one-third; about three-fifths of the increase represented investment (see Figure 2). Government investment was directed largely to labor-intensive projects such as construction of roads, public buildings, and facilities in Panama City for the 1970 Caribbean Olympic Games. Government

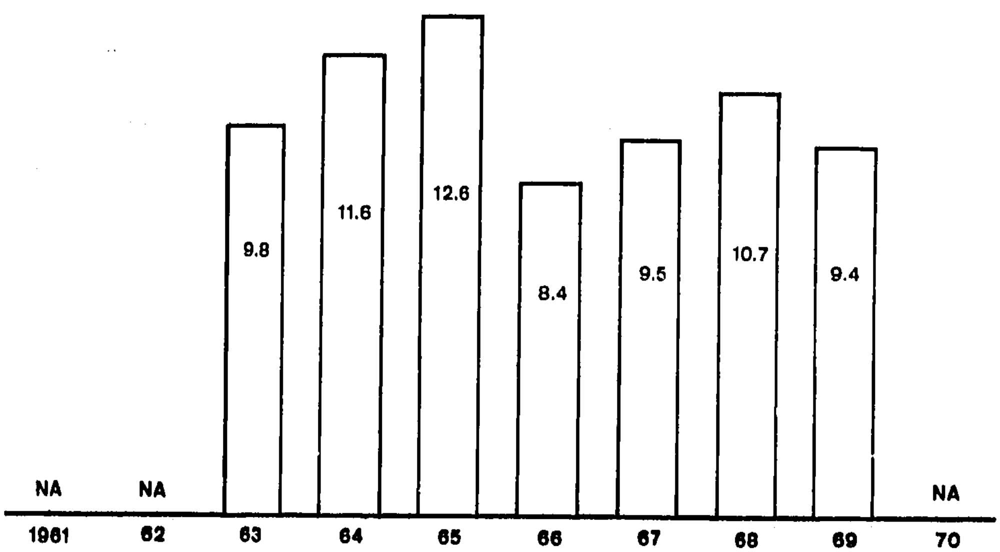
**Panama: Economic Growth and Urban Unemployment**

Figure 1

Real GDP: Percent Change




Urban Unemployment as Percent of the Labor Force

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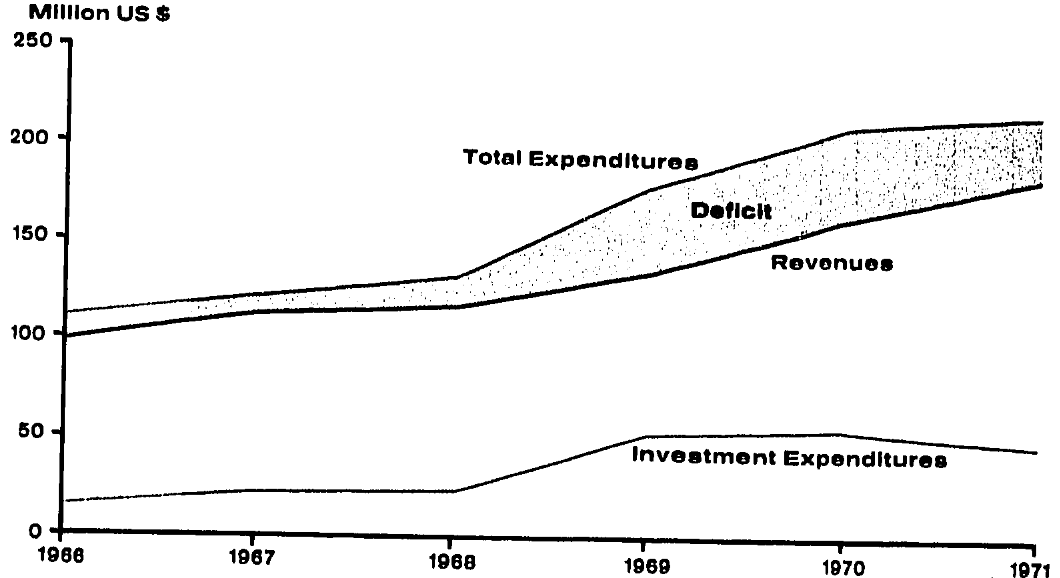
spending more than offset the drop in private investment, cutting the unemployment rate and boosting GDP growth.

**Panama: Central Government Revenues and Expenditures** Figure 2

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6. In 1970, Torrijos sought to woo private investors by dropping or toning down his reformist plans and by removing several populist firebrands from his cabinet. He also attempted to gain favor with non-business groups by increasing outlays for social services, especially education. Central government investment continued to stress domestically planned road construction, but there also was some increase in outlays for electrification and agricultural projects partly financed by the

US Agency for International Development (AID), the World Bank, and the Inter-American Development Bank (IDB). Although investment expenditures remained about the same as in 1969, increased outlays for social services helped to give a 16% boost to total expenditures. Improving business confidence pushed private investment well above the 1968 level, unemployment was cut further, and the GDP growth rate was restored to nearly the pre-1968 level, as shown in Figure 1.

<u>Financing the Deficits in 1969-70</u>

7. Increased government spending created a severe financial pinch in 1969. Considering the magnitude of the increase, the government handled its fiscal affairs reasonably well, but its heavy reliance on short-term borrowing meant greater problems in subsequent years. Although the resumption of rapid economic growth and improved tax administration yielded a 13% rise in revenues, the deficit increased to $47 million -- 26% of expenditures compared with 11% in 1968. The usual sources of deficit financing were clearly inadequate, so the government tapped foreign commercial money markets for about 60% of the needed funds (see the 25X1
table). [redacted] 25X1

8. Panama's financial situation worsened in 1970 despite a tax increase early in the year that helped raise revenues 22%. In addition to financing the resulting $47 million deficit -- unchanged from 1969 -- Panama had to repay foreign obligations of about $20 million, including $15 million borrowed in 1969. Allowing for a small amount of domestic financing, Panama's gross external credit needs thus amounted to $59 million. [redacted] 25X1
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Panama: Central Government
Expenditures, Revenues, and Deficits

Million US $

| | 1969 | 1970 | 1971 Revised Plan |
|---|---|---|---|
| Expenditures | 179.9 | 209.2 | 213.1 |
| Of which: | | | |
| Investment | 52.0 | 53.0 | 47.0 |
| Revenues | 132.7 | 162.0 | 182.5 |
| Deficit | 47.2 | 47.2 | 30.6 |
| Financing the deficit | | | |
| Drawings on external loans (net) | 29.0 | 39.8 | 24.1 |
| Long-term development loans (net) | -0.8 | 0.5 | 2.0 |
| Drawings | 3.2 | 5.1 | 8.0 |
| Repayments | -4.0 | -4.6 | -6.0 |
| Other long-term loans | 0 | 0 | 43.6 |
| Medium-term suppliers' credits | 12.3 | 13.2 | 0 |
| Short-term commercial credits (net) a/ | 17.5 | 26.1 | -21.5 |
| Drawings | 17.5 | 41.1 | 0 |
| Repayments | 0 | -15.0 | -21.5 |
| Domestic financing (net) | 18.2 | 7.4 | 6.5 |
| National Bank | 7.0 | -2.0 | -0.5 |
| Bond issues and other | 11.2 | 9.4 | 7.0 |

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## The 1971 Budget Crunch

9. Greater debt service requirements and the growing difficulty of getting foreign funds have made the financial situation more difficult this year than last. Panama now expects to get $52 million in foreign funds this year, but only $24 million will represent new money to cover the deficit. Even these funds are not now fully assured. [redacted] Panama has had to phase out some of its own make-work road building and other domestically planned projects, with an attendant increase in transitional unemployment.

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10. Limitations on new borrowing are sharply restricting the growth of government expenditure. Allowing for a 13% revenue rise (to $182 million) and net new deficit financing (including domestic borrowing) of $31 million, total expenditures would be able to increase to $213 million -- only $4 million over 1970. However, increases in interest payments on the public debt and a boost in teachers' salaries authorized last year will amount to $10 million. This means that central government investment outlays probably will have to be cut at least $6 million (or 11%) below the 1970 level.

11. The financial squeeze is being exacerbated by the IMF's terms for granting a $14 million standby credit for 1971, which is a condition of the foreign loans. These terms require the government to sharply restrict its use of short-term credit from the National Bank and halt short-term borrowing abroad. The restriction on National Bank credit will make it difficult for the government

to adjust to temporary discrepancies between revenue and expenditure flows during the year. It has already caused the government problems in meeting its March payroll. [redacted] 25X1

<u>Prospects</u>

12. The government's prospects for avoiding financial difficulties during the rest of 1971 and the following two years depend partly on private investment trends. If private investment continued to rise significantly, as now seems unlikely, the government would be under less pressure than in the recent past to increase expenditures and might even reduce them. If private investment is sluggish, the government will be under severe pressure to further increase outlays in order to prevent increases in unemployment, but higher outlays could create grave difficulties unless new sources of revenue are found.

13. The outlook for private investment seems only fair. Elements of strength this year -- the extremely high liquidity of private foreign-owned banks and a prospective small upswing in direct foreign investments in banana plantations and tourist facilities -- are being offset by the adverse effects on business confidence of the return of two populist extremists to the cabinet in the April shuffle. If the government turns to a more radical course, private investment might suffer severely. In any case, private investment probably will be sluggish because of a decline in opportunities for import substitution -- the main stimulant to manufacturing expansion before 1968. Thus, Panama's prospects for maintaining rapid economic growth and checking urban unemployment in the coming years may depend on continuing a fairly high level of central government investment.

14. Panama probably cannot continue to rely on private foreign banking sources for a major part of the funds it needs. It will have to find new financing sources to maintain, much less expand, government spending. Relying more heavily on the

international financial agencies such as the World Bank and the IDB to finance the external costs of its investment projects would not be a solution. Panama would still need additional funds to provide its share of the costs of these projects.

15. Panama will press for financial benefits under the upcoming Panama Canal treaty negotiations. These offer the prospect of greatly increased direct Canal receipts and an expanded tax base as its jurisdiction is extended into the present Canal Zone. Financial considerations undoubtedly were an important factor in Torrijos' move last year to reopen negotiations. The 1967 draft treaty -- never ratified by either party -- provided for direct payments to Panama of nearly $20 million annually, compared with the present $1.9 million annuity, and Panama undoubtedly will seek more in a new treaty. However, it will take time to complete negotiations and ratify the treaty in both countries, and it seems doubtful that Panama can count on funds from this source much before the end of 1973.

16. Panama might consider abandoning its use of the US dollar and shifting to a dollar-linked currency, as authorized by the present Canal treaty. The change would permit Panama to print money to finance immediate government deficits. Over the longer term, however, such a step would be largely self-defeating. The inflationary pressures generated and the stringent exchange controls that probably would be required would discourage direct US investment and consequently add to Panama's problems. Alternatively, Panama might substantially raise taxes this year or next. Always an unpleasant choice, such action would be doubly painful in Panama's case because the tax burden is already well above the Latin American average and thus might also discourage direct US investment.

17. In sum, Panama seems likely to encounter continuing financial difficulties over the next few years. The probable failure of private investment to regain its former buoyancy will generate great pressure for further government compensatory action. At the same time, the government faces growing difficulty in acquiring sufficient funds to enlarge its spending while repaying debts

incurred earlier. The general outlook consequently is for appreciably slower economic growth than before Torrijos' takeover and a renewed rise in the unemployment rate.